

# **Secret Signals: Ex-Telecom CEO Fields 'Black Box' Trial Defense --- Qwest's Nacchio, to Fight Insider Trading Charge, Cites Classified Dealings**

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Nearly five years after he left the former telecom highflier Qwest Communications International Inc., Joseph Nacchio is set to go on trial for insider trading. The government claims he sold \$100.8 million of Qwest stock in 2001 while knowing that financial woes were mounting at the company he led as chief executive. Jury selection starts Monday in Denver federal court.

But what seemed a straightforward insider-trading case now is looking more like a spy saga. Mr. Nacchio, while acknowledging he sold shares right before the stock plunged in 2001 amid poor financial results, maintains that he actually was personally upbeat about Qwest's prospects while he was cashing out.

His reason: He had classified information about big national-security-related federal contracts that he thought Qwest would win. These "black book" contracts, as they're known in the industry, would have kept its results in line with expectations, his lawyers say in pretrial filings.

There is evidence Mr. Nacchio had access to the highest levels of government. To that point, court filings show that Mr. Nacchio met in the White House with such high-level figures as Condoleezza Rice and Richard Clarke in early 2001 about telecom-related national-security issues. The defense may bring up the meeting at the trial.

Government lawyers representing four clandestine agencies -- so secret their names can't be mentioned in court -- have aggressively fought the release of

much of the classified material sought by Mr. Nacchio. Prosecutors say the whole national-security aspect of his defense is a smokescreen with no relevance.

The stakes are high for Mr. Nacchio, a charismatic and brash telecom veteran now 57 years old. If convicted on many of the 42 insider-trading counts, he could conceivably face life in prison. Legal experts say a maximum of 10 years would be more likely, given how judges interpret sentencing guidelines in such cases. He also could face forfeiture of nearly \$101 million, the value of the stock sold.

Other legal proceedings against Mr. Nacchio, including a Securities and Exchange Commission civil fraud suit against him and six other former Qwest executives, are on hold until after the trial.

The Nacchio criminal case is among the last of a string of high-profile prosecutions of corporate brass brought earlier this decade. It comes at a time when there's been a shift in attitudes toward white-collar crime. Since the White House formed a Corporate Fraud Task Force in July 2002 amid the Enron Corp. and WorldCom Inc. debacles, some of the tough tactics used by the Justice Department have come under criticism. In recent months, the Justice Department has reinforced protections for white-collar defendants that had been eroded.

"The Qwest investigation started in the whirlwind of the corporate fraud cases," says Jacob Frenkel, a defense lawyer at Shulman, Rogers, Gandal, Pordy & Ecker in Rockville, Md. "Now the winds are changing."

Qwest sprang up in the mid-1990s, formed by railroad magnate Philip Anschutz, who in 1997 put Mr. Nacchio in place as CEO to take the business public. Qwest soon took over a Baby Bell, U S West, and set out to build a fiber-optic network to carry Internet traffic world-wide. But many others had the same idea, spending billions to string fiber, and when demand didn't match their dreams, the telecom bubble burst and start-ups hit hard times.

Amid their woes, they sometimes pumped up revenue by swapping fiber-optic capacity and interpreting accounting rules so they could recognize revenue for the capacity they swapped. Amid exposure of this maneuver and the general telecom slump, Qwest nearly slipped into bankruptcy court. Mr. Nacchio resigned in 2002 and the next year Qwest restated two years of results, eliminating \$2.48 billion of revenue for 2000 and 2001.

Mr. Nacchio was indicted in December 2005. The U.S. has had mixed results in prior prosecutions of former Qwest executives. It has charged six besides Mr. Nacchio with insider trading or accounting-related crimes, and won plea deals from four, but none got prison time. Those four are cooperating with prosecutors in the Nacchio case. The two others were acquitted.

For Mr. Nacchio's case, everyone from attorneys to the judge to a court reporter has had to get high-level security clearance. The government has redacted pages of material Mr. Nacchio wants to present. Some are so heavily censored they look blank.

Before reviewing classified materials, Mr. Nacchio and his lawyers must ask the judge for permission, a process that has essentially revealed the defense's strategy. To prepare and review court filings, he and his New Jersey-based lawyers have repeatedly traveled to Washington to review classified information in a Sensitive Compartmented Information Facility, or SCIF.

These facilities are generally steel-lined and protected with copper foil and other materials to block transmissions. Lawyers must check their computers and phones at the door. They must draft any legal briefs concerning the classified material on an old government-issued laptop and hand them over to a security officer, who files the pleading under seal. When the prosecution files response papers, the defense team has to travel to an assigned SCIF in Washington, or another SCIF in Denver, to review them.

It's possible all the jostling over classified material could end up amounting to pretrial gamesmanship. In the runup to the recent perjury trial of former Dick Cheney aide I. Lewis Libby, the parties fought over the use of classified documents. But when the defense didn't put Mr. Libby on the stand, the judge curtailed the use of the information.

Mr. Nacchio's lawyers have also raised more-traditional defenses. Their filings say that what he knew about the company's finances when he sold stock wasn't "material" information requiring disclosure to investors. The defense also is expected to argue that Mr. Nacchio sold stock for personal reasons having nothing to do with any confidential information he had.

He and his lawyers are navigating murky legal terrain outlined in the Classified Information Procedures Act. That 1980 federal law lays out procedures for courts and lawyers to follow to access classified files. Congress enacted it after some government officials had evaded prosecution by threatening to reveal classified information at trial, a practice known as "graymail."

Prosecutors have said in pretrial maneuvering that the national-security elements of Mr. Nacchio's defense are a red herring, in part because Qwest's revenue from government contracts was too small to offset other problems Mr. Nacchio knew were mounting at the company.

Moreover, prosecutors say any classified contracts Qwest was working on would have been included in its reports and financial projections under the broad category of government revenue. Mr. Nacchio's court filings say he couldn't share his optimistic outlook with his underlings because they didn't possess the same security clearances. Information about whether the contracts ever materialized is elusive; court hearings where that information could have surfaced have all been closed. Mr. Nacchio's state of mind -- which includes whether he believed the contracts were coming -- is a crucial component to the insider-trading charges, the judge has ruled.

Mr. Nacchio, a grandchild of Italian immigrants to New York, got into telecommunications in 1970 with an engineering job at the old American Telephone & Telegraph Co. He rose to chief engineer and was part of a plan to upgrade AT&T's national network with fiber optics. Eventually he became president of the company's consumer unit, where he stood out for marketing a popular pricing plan, before Mr. Anschutz hired him to lead Qwest.

Mr. Nacchio helped catapult Qwest from an unknown private business into a major phone company with the acquisition of U S West. As he pitched his plan for a world-wide fiber network to investors and potential customers, Mr. Nacchio also shopped it around Washington.

Mr. Nacchio did obtain some government contracts for Qwest in the late 1990s, according to defense filings. The filings say Mr. Nacchio discussed Qwest's business -- including possible contracts for secret equipment hubs and plans for classified networks in the Middle East -- with key government officials. If the government offered Qwest contracts along these lines, evidence to this effect isn't in the public domain at this point.

In the first half of 2001 -- the period when Mr. Nacchio was selling tens of millions of dollars of Qwest stock -- he was a member of the President's National Security Telecommunications Advisory Committee, a group of technology executives that discussed security matters. He had security clearance and the defense maintains that he learned through his membership that the government wanted to shift its classified communications to fiber networks to avert cyber-terrorism.

In March 2001, according to the defense, Mr. Nacchio met in the White House situation room with Ms. Rice, then President Bush's national-security adviser, and Mr. Clarke, then chief counterterrorism adviser on the National Security Council. The filing says Mr. Clarke asked if it was possible to create telecom infrastructure for the government that wasn't connected to any public networks, according to a defense filing.

"Nacchio responded that not only was it possible but that he had already done it," says the filing, which consists of notes of a federal investigator's interview with a former Qwest manager. Mr. Nacchio "went on to describe how he would do it and there was a debate on the subject," according to the notes.

At the time, in early 2001, Qwest's finances were floundering. The telecom bubble was bursting, and Qwest had begun accounting moves for which it later drastically restated income.

According to federal prosecutors, Mr. Nacchio had begun selling stock in January 2001 even as another Qwest executive warned him about the company's financial problems. Mr. Nacchio has said in pretrial filings that he believed those warnings to be wrong because he thought Qwest was in line to receive lucrative government contracts that his fellow executives didn't know about.

In May 2001, Mr. Nacchio completed the stock selling that the government labels insider trading. Two months later, at the National Security Telecommunications Advisory Committee, Mr. Nacchio was officially named vice chairman. A year later -- amid probes of Qwest's accounting and bleak financial results -- Qwest directors asked for and received his resignation as CEO.

In his criminal case, secret federal agencies have repeatedly objected to handing over material to Mr. Nacchio, saying that to do so would cause "exceptionally grave damage," according to the trial judge's notations in one filing. One clandestine agency argued that giving up the material would create "diplomatic tensions which would adversely affect the nation's foreign relations," the filing said.

Last August, the defense team was asked to leave a hearing while representatives from one agency and the prosecution discussed the material, according to a court transcript. During the hearing, the federal judge in Denver,

Edward Nottingham, became frustrated with the government's demands for secrecy.

"I'm unhappy with this agency, very unhappy," said Judge Nottingham, according to the transcript. "If it is so important and so top secret and so critical why is it in here? Why am I even looking at it?" He added: "That's the trouble with all of these secret proceedings . . . everybody thinks there's a lot there and there really isn't."

Because of the national-security angle, the case is being watched closely in some Washington circles. Mr. Nacchio's lawyers roiled government officials last year by alleging that as Qwest's CEO, Mr. Nacchio had refused a government request for access to Qwest's customer phone records.

The case is also attracting attention in Denver, Qwest's hometown. Although the company is still operating, thousands of employees lost their jobs and pension savings in the aftermath of its sinking fortunes and cratering stock. Some locals have vilified Mr. Nacchio, who even while heading the Denver company kept his main residence in New Jersey. "He came into town on his high horse telling everybody what he was going to do and what happened obviously was the company went down the sewer," says Nelson Phelps, executive director of the Association of U S West Retirees and a longtime critic of Mr. Nacchio.

Whether Mr. Nacchio will testify is unclear. The SEC civil complaint describes him as having an "explosive temper" that some legal experts say could hurt him on the witness stand. The SEC filing, in federal court in Denver, quotes an executive as saying, "People were just afraid of the man." Friends and former co-workers say he was merely an aggressive and extremely driven boss.

Mr. Nacchio is deeply involved in his own defense, poring over documents and offering suggestions to his legal team, friends of his say. The possibility of losing

his liberty has taken a toll on his health, they say, adding that Mr. Nacchio has sought medical treatment for several stress-related health issues.

A devout Catholic, he has turned to his faith for solace, says a onetime college roommate, David Miller. The trial is scheduled to begin on the Feast of St. Joseph, a Catholic holiday that has special resonance with Italians and for Mr. Nacchio, who shares a name with the saint. Friends say Mr. Nacchio considers this a positive sign.